

FEDERAL RESERVE

Central Bank Cooperation

BY VANESSA SUMO

Central banks have a long history of working together, but is there still scope for future cooperation?

In the midst of the credit market turmoil last year, the world's major central banks got together in a surprise move to help ease the liquidity squeeze. Central banks were compelled to act — not alone but in a coordinated fashion — because of the international nature of events in the markets. Although critics of this synchronized action say that it does not address the underlying reason why market participants fret about lending, their move was considered far less controversial than past episodes of central bank cooperation.

One well-known controversial example was when Britain returned to the gold standard after World War I. Britain struggled for many

years to keep a fixed rate of exchange between gold and sterling. Part of the problem was how to address a weak domestic economy and at the same time maintain this peg. If the Bank of England eased monetary policy to shore up economic activity, then it would risk gold flowing out of the country

and complicate the task of defending the peg. Fortunately for Britain, New York Fed President Benjamin Strong's close friendship with Bank of England Governor Montagu Norman made Strong sympathetic to Britain's economic woes.

Strong was instrumental in the Fed's decision to reduce interest rates in the fall of 1927 supposedly to help Britain. Lower interest rates in the

United States allowed Britain to avoid raising its own interest rate, which would have been counterproductive for its slumping economy. At the same time, the rate cut took some pressure off of Britain's gold peg, because a wider difference between British and U.S. interest rates encouraged gold flows to Britain.

But the Fed's action also meant that credit conditions would be looser in the United States. Indeed, President Herbert Hoover would later blame Strong and Fed policies at that time for the stock market boom and the eventual bust of 1929, and subsequently the Great Depression. Whether this instance of one central bank helping out another actually led to disastrous results is unclear. (Others have argued that the Fed's decision to expand monetary policy was taken mainly for domestic reasons, because of concerns that a rise in interest rates in Britain would depress demand for U.S. exports.)

Central banks cooperate to achieve common goals. This can be accomplished by sharing information, jointly setting standards, collectively intervening in a financial crisis, and coordinating exchange rates and monetary policy. However, cooperating can be complicated, especially if central banks engage in a deeper form of cooperation. For instance, coordinating exchange rates requires following a policy that may be inconsistent with a country's domestic economic conditions. A central bank will then have to weigh the costs of giving up its independence and influence over the economy against the benefits of cooperation.

But aside from this difficulty, tightly linked capital markets and favorable changes in the way central banks conduct monetary policy have cast some doubt on whether coopera-



They speak the same language: Bank of England Governor Mervyn King, left, talks with former Federal Reserve Chairman Alan Greenspan, center, and European Central Bank President Jean-Claude Trichet, right, at a G20 finance ministers and central bank heads meeting in November 2004.

tion should continue in the future. “If central banks are focused on domestic price stability, and if domestic financial stability is assured by adequate governance and regulatory standards (albeit likely to be internationally negotiated), what further role is there for international cooperation?” asked William White, an economist at the Bank for International Settlements (BIS) at a 2005 BIS conference on central bank cooperation. “Globalized” financial and goods markets might imply that coordination is not only beneficial but also necessary to manage spillovers of a country’s policies on others. However, if central banks keep their domestic affairs in order, then the rationale for international cooperation is weaker.

Ways to Work Together

In October 1979, the Federal Reserve announced an abrupt change in operating procedures to fight rapidly rising inflation in the United States. Interest rates shot up and were kept at very high levels, even if that meant risking a recession. The Fed’s efforts eventually tamed inflation, but not without affecting economies abroad. Latin American countries, in particular, had borrowed heavily from international creditors at floating interest rates. So when rates in the United States (and Europe) went up, Latin American countries struggled to pay their debt. Moreover, demand for their exports weakened as the United States and other countries slipped into a recession, which crippled their ability to earn much-needed foreign currency.

Latin America’s debt crisis was worrying because some of the world’s biggest banks had lent heavily to these countries and were not sufficiently capitalized to cover these exposures. The situation had the potential to destabilize the world’s financial system. So when the crisis erupted in Mexico in August 1982, the Federal Reserve and the Japanese and European central banks moved swiftly to offer a “bridge” loan of \$1.85 billion

to help Mexico until it reached an agreement with the International Monetary Fund to sort out its financial problems. “We didn’t have to spend a lot of time explaining to each other the nature of the emergency,” wrote Paul Volcker, chairman of the Federal Reserve from 1979 to 1987, in a book that he co-wrote on international monetary affairs.

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Central banks have banded together in similar ways in the past. They cooperated to lend support to Mexico in its 1982 financial crisis. In December 2007, central banks simultaneously injected liquidity in the banking system when banks became increasingly cautious in the interbank credit market. Central banks have also chosen to collectively intervene in currency crises, such as the various efforts to save the gold standard and the Bretton Woods fixed exchange rate system.

But cooperation does not always involve a “rescue.” The experience in Latin America in the early 1980s, for instance, highlighted the need to set capital adequacy standards for banks worldwide. Banks serve an important economic role and often take on a high degree of leverage to carry out that role. Banks also have privileged access to central bank funds and their deposits are federally insured. Consequently, there is a strong need to make sure that banks aren’t taking on too much risk. A global convergence of such standards is desirable because the collapse of a number of financial institutions could affect other intermediaries throughout the world. And as banks increasingly compete interna-

tionally, it is important that they face regulatory environments which aren’t too different.

This common recognition drove central banks and financial supervisors of industrialized countries to write and adopt the 1988 Basel Accord. It sets forth guidelines to measure the minimum amount of capital that banks ought to have in relation to the risk they carry. Despite criticisms and shortcomings, the Basel Accord is widely viewed as having achieved its purpose of promoting more consistent regulation across countries. The implementation of the second Basel Accord, which takes into account the complexity of the structure and practices of banking and financial markets today, is now under way.

But perhaps the easiest form of cooperation is in sharing information that central bankers can use to make policy. Indeed, this is what Beth Simmons of Harvard University called “shallow cooperation” at the BIS conference. Its importance, however, should not be understated. Providing each other with quality and timely economic and financial data allows central bankers to compare, assess, and discuss how changing conditions can potentially affect the economy at home. Simmons says that central banks can also share information by “showing one’s hand” — that is, by communicating policy preferences and policy choices which may soon be implemented. And it also helps when central bankers talk to each other about their understanding of how the economic world works, knowing that without basic agreement, central banks would be less effective at improving their joint welfare.

From Shallow to Deep

Exchange rate and monetary policy coordination is the most ambitious form of collaboration, because it imposes constraints on a monetary authority’s autonomy. That it requires the highest level of commitment is probably why it is also most prone to failure.

When two countries fix their exchange rates, central bankers essentially give up their power to guide the economy using monetary policy. For instance, if a central bank wished to expand the money supply in response to high unemployment, then it would have to eventually sell foreign reserves to maintain the exchange rate. But that would reverse the expansion. Similarly, if the United States experienced high inflation, then countries which have a fixed exchange rate with the dollar would be effectively importing that inflation. Central banks in the other countries would have to (and in fact, do) inflate their economies to keep the exchange rate constant.

The fixed exchange rate regime under the Bretton Woods agreement is an example of this type of cooperation. Signed in 1944, the world's industrialized countries agreed to fix their exchange rate to the dollar, while the United States would peg the dollar to gold. Fixing exchange rates was thought to be an effective way of imposing monetary discipline. No central bank would be able to pursue excessive monetary expansion without breaking the peg. It was also believed to be beneficial to international trade as well as to prevent speculators from destabilizing currencies. However, the demands of such a regime eventually put a strain on this cooperation, particularly in the late 1960s, when accelerating inflation in the United States made it difficult for Germany and other countries to maintain a fixed exchange rate to the dollar. The system eventually collapsed in the early 1970s.

There were also attempts to actively intervene in the exchange rate market after the Bretton Woods era. One rather notorious case involved the efforts of some central banks to weaken what was thought to be an overvalued dollar in the 1980s. America's brittle economy and its large and growing trade deficit was a concern not only for the United States but also for its trading partners. Strong protectionist pressures to discourage imports were building in

Congress at that time, and many feared that lawmakers might give in to such demands. To avoid this possibility, U.S. Treasury Secretary James Baker brought together finance ministers and central bankers of the group of five industrial countries (G-5), which included the United States, West Germany, Japan, France, and the United Kingdom.

In a secret meeting at New York City's Plaza Hotel in September 1985, the G-5 voiced concerns that the large external imbalances and the threat of protectionism "could lead to mutually destructive retaliation with serious damage to the world economy." They agreed that "exchange rates should play a role in adjusting external imbalances" and that they would "stand ready to cooperate more closely to encourage this [appreciation of other currencies against the dollar] when to do so would be helpful." A weaker dollar would improve the U.S. trade balance and help lift the economy out of a recession, which would in turn increase demand in the long run for other countries' exports. Moreover, it would head off the possibility of protectionist measures that might trigger similar policy responses from other countries. A concerted effort followed to sell dollars in the foreign exchange market. The dollar fell sharply throughout 1986.

Following the Plaza Accord, Volcker was under pressure to lower interest rates to prop up the domestic economy. Indeed, the Reagan administration had made known its desire for lower interest rates. But Volcker hesitated to move in this direction for fear of a runaway decline in the value of the dollar. He finally agreed to lower interest rates, but only if he could get the German and Japanese central banks to likewise lower their rates, so that the difference between the domestic and foreign return on capital, which determines the flows of funds and therefore the exchange rate, would remain the same. The central banks agreed and the coordination was carried out in March and

April of 1986. Such cooperation would be highly unusual today.

However, the continued fall in the value of the dollar started to worry other countries, particularly Japan with its export-driven economy. In a meeting at the Louvre in Paris in February 1987, finance ministers and central bankers of the Plaza Accord group (plus Canada) agreed that "further substantial exchange rate shifts among their currencies could damage growth and adjustment prospects in their countries." Again, there was concerted exchange rate intervention, but this time in the other direction. Central banks bought dollars and sold local currency, which effectively increased the domestic supply of money. Some analysts say that Japan's monetary easing, following these controversial episodes of cooperation, contributed to the financial and real estate bubble that plagued the country in the late 1980s.

Cooperation and Its Discontents

Arguments for coordination are often made in reference to situations like a world shock that hit all countries (an oil price spike, for instance). A central bank might respond by tightening monetary policy to prevent a rise in the overall price level. Higher interest rates would dampen demand for domestic goods, and bring about a stronger currency that would make imports cheaper and keep prices low.

If a neighboring central bank, however, follows a similar strategy, then the exchange rate between the two countries' currencies will stay more or less the same. If each of the central banks responds with even more tightening to get the desired exchange rate appreciation, then they would eventually succeed in bringing down inflation, but only at a high cost in terms of output. Had the two countries coordinated their actions and agreed not to tighten as much, then inflation would be stabilized and the reduction in output and employment would not be as high. Therefore, countries would be better off if central banks coordinated monetary policy.

This argument for cooperation, though, is incomplete. In a 1985 paper, Harvard University economist Kenneth Rogoff notes that such monetary policy cooperation can also be counterproductive if it exacerbates the central banks' credibility problem; that is, the temptation to inflate the economy in order to increase employment. When a central bank expands monetary policy, interest rates fall and the exchange rate depreciates. A weaker currency makes imports more expensive and causes price levels to go up, which provides an automatic check on a central bank that is also concerned about inflation.

But if two countries coordinate their monetary expansion, then the exchange rate between their currencies will not change. This increases a central bank's incentive to give in to the temptation of inflating the economy because of the greater effect on employment. However, because workers anticipate this incentive to inflate, they will demand higher wages. The result is a higher long-run inflation rate than if countries acted unilaterally. Thus, cooperation can only produce a better outcome if central banks can credibly suppress these inflationary impulses.

During the past few decades, central banks of industrialized countries have made substantial progress in mitigating the commitment problem in monetary policy, says Rogoff. Moreover, goods and financial markets are now more tightly linked than ever. Both factors seem to suggest that countries could benefit substantially from monetary policy coordination.

However, Rogoff, in a 2002 paper with economist Maurice Obstfeld of the University of California, Berkeley,

finds that on the contrary "this lack of coordination may not always be a big problem." The argument for cooperation in the face of world shocks actually weakens when the monetary authority can credibly commit to keeping prices stable, because they can do so successfully without imposing a large cost on output and employment. When that happens, the benefit of cooperation may be much smaller.

With respect to country-specific shocks, or shocks that hit one country but not another, central bank cooperation may also be unnecessary as capital markets become more integrated. Central bankers may not need to be called upon to sort out shocks of this nature, since countries can borrow from each other through financial markets to smooth consumption when times are tough. Hence, the case for monetary policy cooperation may be much weaker.

The Future of Cooperation

Although central bank cooperation has gone through many ups and downs over the last century, the broader trend that economist Barry Eichengreen of the University of California, Berkeley, sees is that cooperation has grown. Advances in communication and transportation technology have reduced the costs of sharing information, and institutions like the BIS have provided a venue to regularly exchange information and expertise concerning monetary policy.

Perhaps more important, cooperation has grown over time because monetary policymakers now speak the same language. "One can make compelling arguments that the rise of a common monetary policy paradigm — namely, the belief that independent

central banks should target low and stable rates of inflation and pursue other objectives to the extent that they do not conflict with this core mandate — is a key explanation for their ability to cooperate," said Eichengreen at the BIS conference. He cites the experience of monetary policy coordination among the European Union group of central banks — the European System of Central Banks (ESCB) — which would have been more difficult had they not agreed on the primary objectives of low and stable inflation. Eichengreen also notes the success of central banks and regulators in establishing and adopting capital adequacy rules for banks, reflecting a common recognition of a market-led financial system.

But while central banks that understand each other may have a greater ability to work together, Rogoff and Obstfeld's finding suggests that countries may be just as well-off if central banks don't cooperate, as long as they follow good policies to ensure price and financial stability. This is because in recent decades, countries can increasingly depend on their own abilities to fight inflation without a costly impact on output, and on internationally integrated capital markets to insure themselves against country-specific shocks.

Even so, the ability to follow sound policies has been helped along by the exchange of information and views between central banks, and by harmonized standards — especially with respect to financial stability — that these monetary authorities helped to establish. Thus, the future may be brighter for these types of cooperation, but less so for exchange rate and monetary policy coordination. **RF**

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